

**Letter Report: Additional Controls Are
Necessary to Ensure that All Businesses Are
Classified by Their Principal Business Activity**

August 2001

Reference Number: 2001-30-117

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 2, 2001

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Letter Report – Additional Controls Are Necessary to
Ensure that All Businesses Are Classified by Their Principal
Business Activity

This report presents the results of our review of Principal Business Activity (PBA) codes. Our objective was to determine the effectiveness of Internal Revenue Service (IRS) efforts to identify businesses by their PBA code.

In summary, the IRS successfully adopted the new North American Industry Classification System, which uses the new six-digit PBA code. However, the IRS has not taken advantage of the opportunity to immediately identify taxpayers' PBA codes when the taxpayers are first established on the IRS' computer system. Also, processing controls are not sufficient to ensure that a valid PBA code is identified for all business-related tax returns filed.

We recommended that management identify business taxpayers by their principal business activity from information provided by the taxpayer when an Application for Employer Identification Number (Form SS-4) is filed. Early identification by PBA code would allow the IRS to include these new businesses in market segment analyses to identify the need for educational or compliance assistance. We also recommended that management implement processing controls to identify Individual Masterfile tax returns with invalid or missing PBA codes and Business Masterfile tax returns with invalid PBA codes for research and correction during processing.

The Commissioner, Small Business/Self-Employed (SB/SE) Division, agreed that efforts could be made to identify the PBA code when a taxpayer applies for an Employer Identification Number and will determine the cost/benefit of implementing such programming and procedural changes. He also plans to determine what additional resources would be needed to implement procedures to perform the validity and correction process and will perform a cost/benefit analysis to make certain that the benefits justify the costs. His staff will consider the availability of funding for these changes and any adverse impact on returns processing or other areas. Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included in Appendix IV.

We considered the request of the Commissioner, SB/SE Division, in the response to the draft report, concerning the number of taxpayer accounts impacted. We reduced our estimate of the number of tax accounts impacted from 3.5 million to 2.8 million. Appendix III contains details of our computation of the number of taxpayer accounts impacted.

Copies of this report are also being sent to the IRS managers who are being affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

Letter Report: Additional Controls Are Necessary to Ensure that All Businesses Are Classified by Their Principal Business Activity

Objective and Scope

The objective of this review was to determine the effectiveness of IRS efforts to identify taxpayer businesses by their PBA code.

The objective of this review was to determine the effectiveness of Internal Revenue Service (IRS) efforts to identify taxpayer businesses by their Principal Business Activity (PBA) code.

Using attribute-sampling techniques, we selected two statistically valid samples (one with no PBA codes and one with invalid PBA codes) from the total population of U.S. Individual Income Tax Returns with Profit or Loss from Business (Schedule C) and/or Profit or Loss from Farming (Schedule F) attached, filed during calendar year 2000, to:

- Assess the adequacy of processing controls to identify and correct missing or invalid PBA codes.
- Evaluate the adequacy of the more than 400 North American Industry Classification System (NAICS) codes recognized by the IRS to allow taxpayers to accurately code their returns.
- Estimate the percentage of accounts that had sufficient information available to allow the IRS to enter the proper PBA code.

We also contacted the Large and Mid-Size Business (LMSB) and the Small Business/Self-Employed (SB/SE) Divisions to determine:

- What benefits, if any, would be derived from immediately identifying the taxpayer by PBA code upon processing the taxpayer's Employer Identification Number (EIN) application.
- The importance of accurate PBA coding.

We conducted the review at the Brookhaven IRS Campus from November 2000 through February 2001 in accordance with *Government Auditing Standards*. The scope included a review of statistics for nationwide data

Letter Report: Additional Controls Are Necessary to Ensure that All Businesses Are Classified by Their Principal Business Activity

processed to the IRS' Masterfile¹ during calendar year 2000 and a review of sampled accounts processed between January and August 2000.

Major contributors to this report are listed in Appendix I. Appendix II contains the Report Distribution List.

Background

The Statistics of Income (SOI) programs have historically relied upon PBA codes to classify businesses by type of activity. These codes were originally based on the Standard Industrial Classification (SIC)² Index and were used exclusively through 1998 by the IRS. As of 1999, the four-digit SIC-based number was changed to a six-digit number based on the NAICS. The NAICS was developed through a cooperative effort among the governments of the United States, Canada and Mexico. This system was designed with more than 1,000 codes, of which the IRS has adopted approximately 400 for its use. The IRS' Masterfile currently accepts both SIC and NAICS codes.

The PBA codes became a high priority to the IRS after its reorganization to unique business operating divisions.

The PBA codes became a high priority to the IRS after its reorganization to unique business operating divisions. The new LMSB and SB/SE Divisions rely on the PBA codes to profile taxpayers by industry or "market segment." In particular, the IRS' educational and compliance programs are now based on identifying the taxpayers by industry or market segment. In addition, the SOI function continues to rely upon PBA code information to collect, tabulate, and publish industry data from various tax forms.

¹ The Masterfile is the IRS' main computer system containing taxpayer accounts.

² The SIC codes were originally developed in the 1930s to classify businesses by their type of activity.

Letter Report: Additional Controls Are Necessary to Ensure that All Businesses Are Classified by Their Principal Business Activity

Results

The IRS successfully converted to the NAICS. However, the IRS does not identify taxpayers by PBA code at the earliest opportunity, and processing controls do not ensure that valid PBA codes are identified for all business returns.

The IRS successfully converted from the SIC Index to the NAICS. The NAICS codes adopted for IRS use were sufficient to allow the taxpayers to accurately code their tax returns by principal business activity.

However, the IRS has not taken advantage of the opportunity to immediately identify taxpayers' PBA codes when they request EINs and their accounts are first established on the IRS' Masterfile. Also, the IRS does not have sufficient controls to identify and correct all business-related tax returns filed with an invalid or missing PBA code.

As a result, the IRS:

- Cannot identify business taxpayers by their principal business activity for the approximately 2 million EINs issued annually.
- Could not identify approximately 2.8 million individuals with business interests and more than 700,000 corporations and partnerships by their principal business activity for tax returns filed in calendar year 2000.

Business Taxpayers Are Not Identified by Their Principal Business Activity at the Earliest Opportunity

Newly established businesses cannot be identified for pre-filing outreach or compliance activities until they file tax returns with valid PBA codes.

Presently, the IRS cannot identify taxpayers by industry or market segment until the taxpayers provide valid PBA codes with the filing of a U.S. Individual Income Tax Return containing a Schedule C or F, a U.S. Partnership Return of Income, or one of the various U.S. Corporation Income Tax Returns. Therefore, newly established businesses cannot be placed in industries or market segments based on their PBA codes, nor can they be targeted for pre-filing outreach or compliance activities, until they file tax returns with valid PBA codes. With approximately 2 million EINs issued

Letter Report: Additional Controls Are Necessary to Ensure that All Businesses Are Classified by Their Principal Business Activity

annually, this problem affects a great many newly established businesses.

Although the PBA information is available, the IRS had not yet taken the opportunity to use it. When taxpayers file an Application for Employer Identification Number (Form SS-4), their accounts are established on the IRS' Masterfile. Even though the principal business activity is described on the Form SS-4, taxpayers are not required to enter PBA codes, nor does the IRS use the taxpayer's description of the business to identify the code for entry to the Masterfile at that time.

The PBA codes became a high priority to the IRS after its reorganization to unique business divisions. The LMSB and SB/SE Divisions rely on knowledge of taxpayers' principal business activities for possible inclusion in educational and compliance programs.

A survey of top managers in the SB/SE and LMSB Divisions indicated that identifying taxpayers by PBA code information at the time the Form SS-4 is processed would enable the IRS to:

- Provide specialized educational materials to the newly formed businesses based upon knowledge of compliance issues common to that industry or market segment.
- Analyze trends reflecting a decline in new businesses for a given industry or market segment to obtain early indications of economic factors that might give rise to compliance issues. This would enable the IRS to engage in focused research or other partnering activity designed to prevent future compliance problems.
- Learn more about the time it takes for new businesses to actually enter operations to better assist planning efforts for communication and education products.

Letter Report: Additional Controls Are Necessary to Ensure that All Businesses Are Classified by Their Principal Business Activity

Recommendation

1. The Commissioner, SB/SE Division, should work with the Commissioner, Wage and Investment (W&I) Division, to identify business taxpayers by their principal business activity from information provided on the Form SS-4 for entry to the IRS' Masterfile.

Management's Response: The Commissioner, SB/SE Division, agreed that efforts could be made to identify the PBA/NAICS code at the time of processing Forms SS-4. However, the SB/SE Division is concerned that when taxpayers subsequently file returns, they may not use the code established via the Form SS-4, and thus the code on the return, if valid, would override the prior code, possibly year after year. The Division will look into the advisability of implementing programming to compare the codes. When codes do not match, the SB/SE Division would have to take steps to determine if either PBA code is accurate. The Division will determine the cost/benefit of implementing such programming and procedures.

Business Taxpayers Were Not Always Identified by Their Principal Business Activity When Tax Returns Were Filed

Filing instructions for tax returns with Schedule C and/or Schedule F attached, and for corporations or partnerships, required the taxpayers to code the returns with the PBA code.

Letter Report: Additional Controls Are Necessary to Ensure that All Businesses Are Classified by Their Principal Business Activity

The IRS could not identify the principal business activity for approximately 3.5 million tax returns that were processed during calendar year 2000 with either missing or invalid PBA codes.

The IRS could not identify the principal business activity for approximately 3.5 million tax returns that were filed during calendar year 2000. These tax returns were processed with either missing or invalid PBA codes.

- Approximately 2 million Individual Income Tax Returns containing Schedule C or F were processed with missing codes. This represented 9.6 percent of all tax returns filed with these schedules.
- Just over 780,000 Individual Income Tax Returns with Schedules C or F were processed with invalid codes. This represented 3.7 percent of all tax returns filed with these schedules.
- More than 700,000 business tax returns for corporations or partnerships were processed with invalid codes. This represented 9.8 percent of all corporate and partnership returns filed.

PBA code processing of Individual Masterfile tax returns

There were insufficient controls for handling both missing and invalid PBA codes on Individual Masterfile (IMF) tax returns. Although the IRS had statistical reports identifying the number of invalid and missing PBA codes for IMF tax returns with a Schedule C or Schedule F, the IRS does not have Internal Revenue Manual (IRM) instructions to identify or correct the PBA codes.

Our review of a sample of 615 Individual Income Tax Returns that were processed without a PBA code or with an invalid PBA code present showed that there were sufficient descriptions of the business activities on 491 (80 percent)³ of the tax returns. Use of this information would have allowed the IRS to determine

³ It is our opinion that the 80 percent correction rate would be approximately the same for BMF tax returns filed with an invalid PBA code.

Letter Report: Additional Controls Are Necessary to Ensure that All Businesses Are Classified by Their Principal Business Activity

and enter the proper PBA codes for an estimated 2.8 million of the more than 3.5 million IMF and Business Masterfile (BMF) tax returns filed without a valid PBA code during calendar year 2000.

PBA code processing of Business Masterfile tax returns

The IRS established effective controls for handling business tax returns with missing PBA codes, but not for handling invalid codes. IRM instructions provide for determining the PBA codes for BMF tax returns when the taxpayers do not provide them. This control was effective, as there were no tax returns identified without a PBA code on IRS statistical reports.

However, when there were invalid PBA codes on BMF returns, there were no IRM instructions for either correcting them or for corresponding with taxpayers to determine the correct codes.

The SB/SE and LMSB Divisions rely on the PBA code information to assist them in achieving their missions of providing customer service through education while helping taxpayers to understand and comply with the tax laws. For example, NAICS was recently used to identify employers in the beauty and barber industry to analyze tip wage compliance. When valid codes are present, tax returns can be more accurately profiled by industry or market segment, especially for focusing education and compliance programs.

Both education and compliance activities are now focused by industry or market segment. With increased knowledge of industry filings and potential compliance problems, pre-filing initiatives can be developed to foster compliance and eliminate more costly and intrusive post-filing enforcement actions. Further, understanding the characteristics of the filing population could improve the process of allocating IRS resources. Finally, the SOI Division relies on the accuracy of the

Letter Report: Additional Controls Are Necessary to Ensure that All Businesses Are Classified by Their Principal Business Activity

PBA code data to produce reports on which many government agencies rely.

Recommendation

2. The Commissioner, SB/SE Division, should work with the Commissioner, W&I Division, to implement processing controls to identify IMF tax returns with invalid or missing PBA codes, and BMF tax returns with invalid PBA codes for research and correction during processing.

Management's Response: The Commissioner, SB/SE Division, stated that the Division would need additional resources to perform the validity and correction process. The SB/SE Division will perform a cost/benefit analysis to make certain the benefits would justify the cost to perform this work and, ultimately, whether such funding is available. In its analysis, it will consider any impact which may delay the processing of returns, thus adversely impacting customer service. The SB/SE Division will also address concerns raised by the SOI, including whether it will have access to the original codes designated by the taxpayer after the correction process.

Conclusion

The IRS successfully converted to the NAICS. However, the IRS is not fully effective in its efforts to identify taxpayers by their principal business activities. Taxpayers are not initially identified by their PBA codes when they obtain EINs, and processing controls do not ensure that every tax return is processed with a valid PBA code. As a result, newly established businesses are not identified by their business activity for outreach or compliance activity. Also, approximately 3.5 million business returns were processed with either a missing or invalid PBA code in calendar year 2000.

**Letter Report: Additional Controls Are Necessary to Ensure that All Businesses
Are Classified by Their Principal Business Activity**

Appendix I

Major Contributors to This Report

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and
Corporate Programs)

Richard J. Dagliolo, Director

Robert K. Irish, Audit Manager

Daniel A. Zaloom, Senior Auditor

Paul R. Baker, Auditor

Margaret Filippelli, Auditor

Layne Powell, Computer Specialist

**Letter Report: Additional Controls Are Necessary to Ensure that All Businesses
Are Classified by Their Principal Business Activity**

Appendix II

Report Distribution List

Commissioner N:C
Deputy Commissioner N:DC
Commissioner, Large and Mid-Size Business Division LM
Chief Counsel CC
Deputy Commissioner, Large and Mid-Size Business Division LM
Deputy Commissioner, Small Business/Self-Employed Division S
Deputy Commissioner, Wage and Investment Division W
Director, Communications, Small Business/Self-Employed Division S: COM
Director, Internal External Stakeholders, Small Business/Self-Employed Division
S:C:CP:I
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
National Taxpayer Advocate TA
Office of Management Controls N:CFO:F:M
Director, Legislative Affairs CL LA
Audit Liaisons:
Commissioner, Large and Mid-Size Business Division LM
Commissioner, Small Business/Self-Employed Division S
Commissioner, Wage and Investment Division W

Letter Report: Additional Controls Are Necessary to Ensure that All Businesses Are Classified by Their Principal Business Activity

Appendix III

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

Reliability of Information – Actual; 2,800,421 taxpayer accounts impacted (see page 6).

Methodology Used to Measure the Reported Benefit:

Review of an Internal Revenue Service (IRS) report containing statistics for all missing and invalid Principal Business Activity (PBA) codes for tax returns filed in calendar year 2000 showed that the IRS was unable to identify the Principal Business Activity:

- For many Individual Masterfile (IMF) accounts with income or loss from business or farming because there were 2,002,250 tax returns with no PBA code entered and 780,108 tax returns with an invalid PBA code entered.
- For many Business Masterfile (BMF) accounts for corporations or partnerships because there were 718,169 tax returns with an invalid PBA code entered.

During our review we identified an 80 percent correction rate for IMF tax returns processed with invalid codes or processed without codes by determining the principal business activity from information found on tax returns with missing or invalid PBA codes. It is our opinion that the 80 percent correction rate for BMF tax returns filed with invalid PBA codes would be approximately the same.

We applied the 80 percent correction rate to the IMF universe of 2,782,358 as shown above, to arrive at a total of 2,225,886 tax returns that could have been corrected. We also applied the 80 percent correction rate to the BMF universe of 718,169 as shown above, based on the IMF test results, to arrive at a total of 574,535 tax returns that could have been corrected.

Therefore, the estimated total number of tax returns that could have been corrected was 2,800,421.

Letter Report: Additional Controls Are Necessary to Ensure that All Businesses Are Classified by Their Principal Business Activity

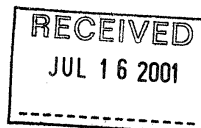
Appendix IV

Management's Response to the Draft Report



SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224



JUL 16 2001

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Joseph G. Kehoe *Handwritten: Auditor / Prelim*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Letter Report: Additional Controls Are Necessary to Ensure that All Businesses Are Classified by Their Principal Business Activity

Thank you for the opportunity to respond to your draft letter report. My office coordinated the response with the Wage and Investment (W&I) and Large and Mid-Size Business (LMSB) Operating Divisions, and Statistics of Income (SOI). Their comments are incorporated in this response.

As noted in your report we use, the Principal Business Activity (PBA) codes widely within the IRS to identify taxpayers by industry or market segment. SOI has used these codes for many years; in fact, they conduct their own review and validation of the PBA codes to meet the requirements of their program and their customers. Since the mid-1990's, IRS' Research organization has used the PBA codes to identify market segments for their compliance profiles and tests. Most recently, the Small Business/Self-Employed (SB/SE) and LMSB Divisions have been using these codes in their outreach and compliance programs. Ideally, we would prefer that the PBA codes be 100 percent accurate. However, as noted on our response to specific recommendations, we must evaluate this benefit in light of the costs involved.

As requested, we reviewed the proposed outcome measure on the expected impact of your recommended actions on tax administration, i.e., that 3.5 million taxpayer accounts will be impacted. Since this is simply the number of IMF and BMF returns processed in 2000 with missing and invalid PBA codes, we believe you have overstated the measure.

Since the first recommendation in your report deals only with prospective SS-4 applicants, it will not impact on any of these 3.5 million existing business filers. Although the second recommendation deals with perfecting these IMF and BMF returns during processing, a cost/benefit analysis will probably not support perfection of all 3.5 million returns, particularly those requiring correspondence with the taxpayer. Of the 615 IMF returns sampled for the analysis, the report states that we could have perfected about 80 percent based on information provided by the taxpayer. This translates into about 2.2 million IMF returns. Since no similar data are included for the BMF returns, it

Letter Report: Additional Controls Are Necessary to Ensure that All Businesses Are Classified by Their Principal Business Activity

2

is impossible to quantify how many could be perfected. Hence, I recommend reducing the value of the measure based on the facts in the report to 2.2 million returns impacted.

Our comments on the recommendations in this report are as follows:

RECOMMENDATION 1: The Commissioner, SB/SE Division, should work with the Commissioner, Wage and Investment (W&I) Division, to identify business taxpayers by principal business activity from information provided on the Form SS-4 for entry to the IRS' Masterfile.

ASSESSMENT OF CAUSE: We do not require the taxpayer to enter the principal business activity (PBA) code on the SS-4 when filed. The IRS does not use the taxpayer's description of the business to identify the PBA for entry on the Master file.

CORRECTIVE ACTION: We agree efforts can be made to identify the PBA/NAICS code at the time of processing Forms SS-4. However, when taxpayers subsequently file returns, they may or may not use the code established via the SS-4, and thus the code on the return, if valid, would override, possibly year after year. We must look into the advisability of implementing programming to compare the codes. When codes do not match, we would have to take steps to determine which code, if either, is accurate. We will determine the cost/benefit of implementing such programming and procedures to potentially gain only single digit percentage improvements in overall accuracy of these codes.

IMPLEMENTATION DATE: Analysis and decision NLT 12/31/01.

RESPONSIBLE OFFICIAL: Commissioner, SBSE

RECOMMENDATION 2: The Commissioner, SB/SE Division, should work with the Commissioner, W&I Division, to implement processing controls to identify IMF tax returns with invalid or missing PBA codes, and BMF tax returns with invalid PBA codes for research and correction during processing.

ASSESSMENT OF CAUSE: The Internal Revenue Manual (IRM) does not provide instructions to identify or correct the PBA.

CORRECTIVE ACTION: We would need additional resources to implement these procedures to perform the validity and correction process. We will perform a cost/benefit analysis to make certain the benefits would justify the cost to perform this work, and ultimately, whether such funding is available. In our analysis we will consider, any impact, which may delay processing of returns, thus adversely impacting customer service. We also will address concerns raised by SOI, including whether they will have access to the original codes designated by the taxpayer after the correction process.

**Letter Report: Additional Controls Are Necessary to Ensure that All Businesses
Are Classified by Their Principal Business Activity**

3

IMPLEMENTATION DATE: Analysis and recommendations by 12/31/01.

RESPONSIBLE OFFICIAL: Commissioner, SBSE

If you have any questions, please contact Martha Sullivan, Deputy Director, Compliance Policy, Small Business/Self-Employed at 202-622-5563.